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MEMORANDUM

DATE: July 8, 1999

TO: Greg Woods
Chief Operating Officer
Office of Student Financial Assistance Programs

FROM: Gloria Pilotti *Gloria Pilotti*
Regional Inspector General for Audit
Region IX

SUBJECT: FINAL AUDIT REPORT
United Education Institute
Eligibility to Participate in Title IV Programs
ED Audit Control No. A0990002

Attached is our subject audit report presenting our finding and recommendations resulting from our audit of United Education Institute, Irvine, California.

In accordance with the Department's Audit Resolution Directive, you have been designated as the action official responsible for the resolution of the finding and recommendations in this report.

If you have any questions or wish to discuss the contents of this report, please contact me at (916) 498-6622. Please refer to the above audit control number in all correspondence relating to this report.

Attachment

United Education Institute Eligibility to Participate in Title IV Programs

FINAL AUDIT REPORT



**Audit Control Number A0990002
July 1999**

Our mission is to promote the efficient
and effective use of taxpayer dollars
in support of American education



U.S. Department of Education
Office of Inspector General
Sacramento, California

NOTICE

Statements that financial and/or managerial practices need improvement or recommendations that costs questioned be refunded or unsupported costs be adequately supported, and recommendations for the better use of funds, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determinations on these matters will be made by the appropriate Education Department officials.

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Executive Summary

United Education Institute (UEI), a proprietary institution with corporate offices in Irvine, California, did not qualify as an eligible institution for participation in the Title IV Student Financial Assistance Programs. The 1992 reauthorization of the Higher Education Act (HEA) added a provision to the Act that states *“the term ‘proprietary institution of higher education’ means a school . . . which has at least 15 percent of its revenues from sources that are not derived from [HEA, Title IV] funds. . . .”* This requirement is referred to as the 85 Percent Rule. The 1998 amendments to the HEA, enacted on October 7, 1998, changed the provision to require that a proprietary institution have at least 10 percent of its revenue from non-Title IV sources.

UEI received only 8.8 percent of its revenues from non-Title IV sources during its fiscal year ended October 31, 1997. As a result, the institution was ineligible to participate in the Title IV programs as of November 1, 1997. UEI also failed to meet the 10 percent minimum requirement for non-Title IV revenue in its fiscal year ended October 31, 1998. In that year, the institution derived only 6.1 percent of its revenue from non-Title IV sources.

In its fiscal year 1997 financial statements, UEI reported that it met the non-Title IV revenue percentage requirement. UEI’s reported compliance was based on a calculation that used the accrual basis of accounting, rather than the required cash basis. Subsequently, UEI recalculated its percentage using the cash basis, but continued to overstate the percentage of non-Title IV revenues by improperly including an amount for institutional loan principal. This amount did not represent non-Title IV cash revenue received by the institution in accordance with Title 34 of the Code of Federal Regulations (CFR), Section 600.5. UEI also included an amount for institutional loan principal in its fiscal year 1998 calculation.

We recommend that the Chief Operating Officer for the Office of Student Financial Assistance Programs take emergency action to terminate the participation of UEI in the Title IV programs. The Chief Operating Officer should require UEI to return to lenders the Federally-guaranteed Title IV loans disbursed after October 31, 1997. In addition, the Chief Operating Officer should also require that UEI return Federal Title IV grant and Federal Work Study funds received from the U.S. Department of Education (Department) after that date. As of October 31, 1998, UEI had received about \$14.7 million in loans, \$6.9 million in grants, and \$179,000 in Federal Work Study funds for periods after the institution became ineligible.

In its comments on the draft report, UEI did not agree with the finding and recommendations presented. We included UEI’s comments as an attachment to this report.

Audit Results

We concluded that UEI failed to meet the non-Title IV revenue percentage requirements. Specifically, it did not derive at least 15 percent of its revenues from non-Title IV sources during its fiscal year ended October 31, 1997, nor at least 10 percent of its revenues from non-Title IV sources during its fiscal year ended October 31, 1998. UEI overstated its percentage of non-Title IV revenues by improperly including amounts for institutional loan principal in its calculations. Also, as noted in the Other Matters section of the report, UEI did not properly report its Title IV revenue percentage in its fiscal year 1997 financial statements.

United Education Institute Failed to Meet the Non-Title IV Revenue Percentage Requirements

As of November 1, 1997, UEI did not qualify as an eligible proprietary institution of higher education, because it did not have sufficient non-Title IV revenues to meet the minimum requirements. The 1992 reauthorization of the Higher Education Act (HEA) added a provision to the Act that states “*the term ‘proprietary institution of higher education’ means a school . . . which has at least 15 percent of its revenues from sources that are not derived from [HEA, Title IV] funds . . .*” The 1998 amendments to the HEA, enacted on October 7, 1998, changed the provision to require that a proprietary institution have at least 10 percent of its revenue from non-Title IV sources. This institutional eligibility requirement is codified in Title 34 CFR Section 600.5(a)(8). The regulations provide the formula for assessing whether an institution has satisfied the requirement and specify that amounts used in the formula must be received by the institution during its fiscal year. Specifically, 34 CFR Section 600.5(d)(2)(i) states that “. . . *the title IV, HEA program funds included in the numerator and the revenue included in the denominator are the amount of title IV, HEA program funds and revenues received by the institution during the institution’s last complete fiscal year; . . .*”

UEI’s receipts from non-Title IV sources were less than 15 percent of its revenues for fiscal year 1997 and less than 10 percent for fiscal year 1998. The following table summarizes UEI’s calculations and the OIG’s adjusted calculations. The amounts shown are for UEI’s fiscal years ending October 31.

Table 1. Comparative Computations of UEI's Percentage of Non-Title IV Funds. In fiscal years 1997 and 1998, UEI did not have sufficient non-Title IV revenues to meet the minimum requirements.

United Education Institute				
Revenue Received	1997 (15% Minimum)		1998 (10 % Minimum)	
	Per School	Per OIG	Per School ¹	Per OIG
<i>Title IV Revenue:</i>				
Pell Grant	\$4,549,393	\$4,549,393	\$6,477,973	\$6,477,973
Federal Supplemental Educational Opportunity Grant ²	\$310,442	\$232,831	\$507,301	\$380,476
Federal Family Education Loan	\$9,908,332	\$9,908,332	\$14,665,169	\$14,665,169
Perkins Loan Disbursements ³	\$40,401	\$0	(\$927)	\$0
Total Title IV Revenue	\$14,808,568	\$14,690,556	\$21,649,516	\$21,523,618
<i>Non-Title IV Revenue:</i>				
Principal on Institutional Loans	\$1,686,808		\$2,795,446	
Borrower Payments on Institutional Loans		\$182,039		\$287,188
Job Training Partnership Act, Vocational Rehabilitation, Cash	\$1,200,663	\$1,200,663	\$1,064,347	\$1,064,347
Perkins Loan Payments		\$31,968		\$47,396
Total Non-Title IV Revenue	\$2,887,471	\$1,414,670	\$3,859,793	\$1,398,931
Total Revenue	\$17,696,039	\$16,105,226	\$25,509,309	\$22,922,549
Non-Title IV Revenue as a Percent of Total Revenue	16.32%	8.78%	15.13%	6.10%

¹ At the time we completed our review, UEI's fiscal year 1998 calculation had not yet been audited by its Certified Public Accounting firm.

² UEI included funds that it used to meet its matching requirement for the FSEOG Program. In the *Analysis of Comments and Changes* section of the Final Rule, the Secretary stated that an institution should not include institutional matching funds as part of its Title IV Program funds. Title IV revenue should only include funds received from the Federal Government. The elimination of the FSEOG matching funds from the calculation slightly increased the institution's percentage of non-Title IV receipts.

³ The transactions for the Perkins Loan Program include the Federal Capital Contribution (FCC), institutional capital contribution (required institutional matching funds), Perkins Loan disbursements, and borrower payments (principal and interest) on Perkins Loans. We concluded that only the FCC and borrower payments provide an inflow of cash (revenue received) to the institution from tuition, fees and other institutional charges. Therefore, we eliminated the Perkins Loan disbursements from the Title IV funds receipts and included borrower payments received on Perkins Loans in the non-Title IV receipts. (UEI did not receive FCC in fiscal year 1997 or 1998.) The result of these adjustments was a slight increase in the institution's percentage of non-Title IV receipts.

Proprietary institutions that fail to satisfy the non-Title IV revenue percentage requirements lose their eligibility to participate in Title IV programs on the last day of the fiscal year covering the period that the institution failed to meet the requirement. Therefore, the institution was ineligible to receive Title IV funds as of November 1, 1997.

UEI improperly included amounts in its calculations that did not represent non-Title IV revenue received during the fiscal year. UEI originally calculated its fiscal year 1997 non-Title IV revenue percentage using the accrual method of accounting. For our review, UEI provided a cash-based recalculation, but did not fully convert all revenue to the cash basis. UEI continued to include the principal amount for its institutional loans as non-Title IV revenue received in its fiscal year 1997 recalculation and its fiscal year 1998 calculation. This gave the impression that UEI met the required percentages of non-Title IV revenues when, in fact, UEI had not met the requirement. Table 1 shows the amounts that UEI included in its computations.

Amounts used in the non-Title IV revenue calculation must represent revenue received during the fiscal year. Title 34 CFR Section 600.5(d)(2)(i) specified that the amounts to be used in the calculation are Title IV funds and **revenues received by** the institution during the fiscal year. The Financial Accounting Standards Board (FASB) provides a definition of revenue in its Statement of Financial Accounting Concepts No. 6. The FASB defines revenues as “*inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.*” The FASB Statement also states that “*Revenues represent actual or expected cash inflows (or the equivalent) that have occurred or will eventuate as a result of the entity’s ongoing major or central operations.*”⁴ The accounting method that recognizes revenues when amounts are received is referred to as cash basis accounting. In contrast, the accrual basis of accounting recognizes revenue when sales are made or services are performed, regardless of when cash is received.

When the regulation covering institutional eligibility requirements was issued on April 29, 1994, the Department stated its position on including institutional loans as revenue. In the *Analysis of Comments and Changes* section of the Final Rule, the Secretary stated that:

*“An institution is not prohibited from including institutional charges that were **paid** [emphasis added] by... institutional loans as revenue ... provided that the ... loans are valid and not just part of a scheme to artificially inflate an institution’s tuition and fee charges. For this purpose, the Secretary does not consider institutional loans to be real unless such loans are routinely repaid by the student borrowers...”*

In this connection, the Secretary will scrutinize institutions that raise their tuition and fee charges to avoid the 85 percent rule but can show no actual payment of those additional charges, or payment through ‘artificial’ institutional ... loans.”

While the preamble indicates that institutional loans could be included, the regulations stress that revenue used in the calculation must be received. Also, the Secretary specified in the preamble that “*institutions will use a cash basis of accounting for both title IV, HEA program funds and revenues.*” He further explained that “*Under a cash basis of accounting, the institution reports revenues on the date that the revenues are actually received.*”

⁴ FASB’s Statement of Financial Accounting Standards No. 95 defines “cash equivalents” as short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

The institutional loan principal amounts that UEI included in its calculation did not represent revenue received during the fiscal year. The institutional loan principal amounts represent the portion of the loan that the school has earned by providing educational services to the students.⁵ As noted in the previous section, cash basis accounting recognizes revenue when cash is received rather than when services are provided. Therefore, the institutional loan principal amounts should not have been included in the calculation as non-Title IV revenues. Instead, UEI should have included the borrower payments (principal and interest) received on the school's institutional loans during the applicable fiscal year. The amount of borrower payments that UEI received in fiscal years 1997 and 1998 are shown as "Borrower Payments on Institutional Loans" in Table 1.

UEI was ineligible for Title IV funds it received since November 1, 1997. Because it did not meet the non-Title IV revenue percentage requirements for its fiscal year ended October 31, 1997, UEI lost its eligibility to participate in the Title IV programs on November 1, 1997. The following table shows the amount of Title IV funds, as of October 31, 1998, that UEI had received since its loss of eligibility.

Table 2. Title IV Funds Received by UEI from November 1, 1997 through October 31, 1998.⁶ UEI received over \$21 million in Title IV program funds after it became ineligible to participate in those programs.

United Education Institute	
Title IV Funds Received	1998
Stafford Loan (subsidized)	\$6,000,407
Stafford Loan (unsubsidized)	\$7,596,521
PLUS Loan	\$1,068,242
Total Loans	\$14,665,170
Pell Grant	\$6,477,973
Federal Supplemental Educational Opportunity Grant	\$380,475
Total Grants	\$6,858,448
Federal Work Study	\$178,736
Total Title IV Funds	\$21,702,354

UEI has continued to receive Title IV funds for the period subsequent to October 31, 1998.

⁵ We found that UEI's institutional loans were valid, did not appear to be part of a scheme to artificially inflate tuition, and were routinely repaid by student borrowers.

⁶ The grant and loan amounts in Table 2 are the total funds disbursed (net of refunds) as shown by UEI's records. The Federal Work Study amounts were obtained from the school servicer's records.

Recommendations

We recommend that the Chief Operating Officer of the Office of Student Financial Assistance Programs:

1. Initiate emergency action to terminate UEI's participation in the Title IV programs.
2. Require that UEI return to lenders the Federal Family Education Loans received after October 31, 1997. UEI's records showed that, as of October 31, 1998, those funds totaled about \$14.7 million.
3. Require that UEI return Pell Grant, Federal Supplemental Educational Opportunity Grant, and Federal Work Study funds received after October 31, 1997. UEI's records showed that, as of October 31, 1998, the grant funds totaled about \$6.9 million. In addition, the school's servicer's records showed that, as of October 31, 1998, the Federal Work Study funds totaled about \$179,000.

UEI Comments

UEI disagreed with our conclusion and recommendations. UEI stated that the OIG had focused on the word "paid" in the preamble statement on institutional scholarships and loans to argue that the Secretary meant to consider only loan payments received from an external source as an inflow of revenue or cash. UEI claimed that institutions and accountants reviewing the preamble have frequently concluded that the statement clearly meant that institutional loans could be treated as revenue in the percentage calculation. UEI also cited letters countersigned by Departmental staff and conversations with Departmental and OIG staff to support its claim that institutional loans could be treated as revenue in the calculation "in the year in which the loans were made."

UEI claimed that the Secretary had created a "regulatory" basis of accounting governed by rules established in the regulations and other guidance. UEI also stated that the Secretary did not intend that institutions use pure cash based accounting for the calculation. As support for this last statement, UEI referred to the preamble language on using institutional matching funds in the percentage calculation and to regulations covering cash management and the reimbursement payment method.

UEI stated that enforcing the report's recommendations would violate the Department's obligation to apply its regulations uniformly. Also, it stated that UEI was entitled to a "safe harbor" from penalty for fiscal years 1997 and 1998 on grounds that it acted in good faith reliance on instructions given by the Secretary and guidance provided by the Department.

In its response, UEI also included several statements regarding our use of the FASB Concept Statement in the report. It stated that the Concept Statement does not establish a standard and is not a document upon which the OIG can properly rely for its conclusions. It referred to the hierarchy of Generally Accepted Accounting Principles (GAAP), which establishes the order for the most authoritative sources of guidance for an auditor. UEI also stated that the Concept Statement was not intended to define the timing of recognition of revenue.

OIG Response

UEI's comments did not change our position. Recollections of conversations and statements countersigned by Departmental staff do not have the same legal force as regulations issued pursuant to formal rulemaking. Title 34 CFR Section 600.5(d)(2)(i) specifically states that the amounts included in the percentage calculation be Title IV program funds and revenues received by the institution during the institution's fiscal year. The Secretary was explicit in the preamble to the regulations that institutions use "a cash basis of accounting" for both Title IV funds and revenues. Under cash-basis accounting, revenues are recognized when an actual cash inflow to the institution occurs.

UEI's claim that the Secretary had established his own regulatory basis of accounting has no merit. The regulations issued by the Secretary only specified a methodology for calculating a percentage that is to be reported in a footnote to the institution's audited financial statement, not a basis of accounting. Also, UEI's support for the statement that cash-basis, in the context of the regulation, does not mean pure cash-basis is flawed. In the preamble to the regulations, the Secretary did state that matching funds should not be included in the numerator of the calculation. However, the absence of a statement regarding the denominator does not negate other statements contained in the preamble. As noted above and in the report, the Secretary made a clear statement in the preamble that institutions must use a cash basis of accounting for amounts included in the 85 Percent Rule calculation. Regulations governing cash management, the reimbursement payment method, and other requirements of the Title IV program are not applicable to the non-Title IV revenue calculation.

We agree that the Department should uniformly apply its regulations to institutions. However, UEI did not provide any examples to support its statement that enforcement of the regulations as presented in our report would be inconsistent with other enforcement actions taken by the Department. Also, the HEA provision and the regulations covering the non-Title IV revenue percentage requirement do not provide for a "safe harbor." The HEA clearly states the revenue percentage requirement must be met for proprietary institutions to be eligible to participate in Title IV programs. The regulations are clear that institutions failing to meet the minimum percentage lose their eligibility on the last day of the fiscal year covered by the percentage calculation. UEI lost its eligibility to participate in Title IV programs on October 31, 1997. Therefore, it was ineligible for Title IV funds received after that date.

The Concept Statement is an appropriate reference for the definition of the term "revenue." The "revenue" definition is used both in the Concept Statement and in the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide: Not-for-Profit Organizations. The Guide is a Level 2 source in the hierarchy of GAAP. We agree that the Concept Statement does not define the timing for recognition of revenue. The Secretary defined when revenue should be recognized for purposes of the percentage calculations when he specified "cash basis of accounting."

Other Matters

Revenue Percentage Calculation for Fiscal Year 1996. As mentioned in the Purpose and Methodology section of the report, we did not extend our review to include fiscal year 1996. However, a cursory review of UEI's methodology for calculating its revenue percentage for fiscal year 1996 found that the calculation included institutional loan principal amounts and tuition reductions as non-Title IV revenue. These amounts represented over half of the non-Title IV revenues used in the calculation. Since UEI's reported non-Title IV percentage was 15.17 percent for fiscal year 1996, it is unlikely that UEI met the 15 percent minimum requirement in that year.

Footnote Disclosure in Financial Statements. UEI did not properly report its Title IV revenue percentage in its fiscal year 1997 financial statements. Title 34 CFR Section 668.23(d)(4), which was effective July 1, 1997, states that "*A proprietary institution must disclose in a footnote to its financial statement audit the percentage of its revenues derived from the title IV, HEA program funds that the institution received during the fiscal year covered by that audit.*" For UEI's fiscal year 1997 financial statement audit, the CPA firm attached a separate report stating that management's assertion that UEI had complied with the "85 Percent Rule" was fairly stated, in all material respects. The report did not include the percentage of UEI's revenue derived from Title IV funds during the fiscal year. UEI's fiscal year ended on October 31, 1997, which is after the effective date of the regulation. Therefore, UEI should have reported its actual percentage in a footnote to its financial statement audit.

CPA Review of UEI's Percentage Calculation. During our fieldwork, we met with a representative of the CPA firm that audited UEI's financial statements for the fiscal year ended October 31, 1997. Our purpose was to obtain information on the extent of the firm's review of UEI's non-Title IV revenue calculation and its basis for concluding that the calculation was properly performed by the institution. The CPA firm used an accrual-based calculation for its review and for the corresponding report on management's assertion on compliance with the non-Title IV revenue percentage requirements. The representative stated that she first became aware of the cash basis requirement the following year. Also, as noted above, the financial statement audit did not meet reporting requirements, since UEI's actual percentage was not included in a footnote to the financial statements.

Background

United Education Institute was founded in October 1982 in Los Angeles County, California as United Electronics Institute. Currently headquartered in Irvine, California, UEI had seven operating campuses during fiscal year 1997: Los Angeles, Huntington Park, San Diego, Santa Ana, Van Nuys, Ontario, and Burbank. (The Burbank campus has since closed.) UEI offers vocational programs in the computer, medical and business fields, and is accredited by the Accrediting Commission of the Accrediting Council for Continuing Education and Training. UEI uses the services of Mitchell Sweet & Associates (MSA), a third-party school servicer.

During the period November 1, 1996, through October 31, 1997, UEI received about \$14.8 million in Title IV funds from the following programs: Federal Pell Grant, Federal Supplemental Educational Opportunity Grant, Federal Family Education Loan, and Federal Work Study.

Purpose and Methodology

The purpose of our audit was to determine if UEI derived the minimum required percent of its revenues from non-Title IV sources and properly reported its Title IV revenue percentage in its financial statements and, if applicable, to the U.S. Department of Education.

To accomplish our objective, we obtained background information about the institution and identified the Department's Office of Postsecondary Education number under which the institution received its Title IV funds. We reviewed UEI's corporate financial statements and the most recent Student Financial Assistance audit reports prepared by its CPA firms. We conducted interviews with UEI officials and reviewed student records. We assessed whether the institution used the non-Title IV revenue percentage formula in the regulations and reviewed the financial statements for proper disclosure of the percentage.

To achieve our audit purpose, we analyzed data extracted from UEI's student account ledgers, which are maintained on a computerized database. Information from student account ledgers that was used as a basis for our audit conclusion was tied to other sources, such as institutional bank statements, school's servicer's records, and student records. We used data extracted from the Department's National Student Loan Data System (NSLDS) for comparative purposes and reports generated from the Department's Postsecondary Education Participants System (PEPS) for background information purposes.

Our audit covered the institution's fiscal year ending October 31, 1997. After determining that UEI did not meet the non-Title IV revenue percentage requirement for fiscal year 1997 (minimum 15 percent), we expanded our review to include the fiscal year ended October 31, 1998. For this subsequent year, we evaluated the types of revenues included in UEI's calculation and determined that UEI did not meet the minimum 10 percent requirement. We did not extend our review to include fiscal years 1994, 1995, or 1996. (The non-Title IV minimum revenue percentage requirement became effective for the institution's fiscal year ending October 31, 1994.) As we disclosed in the Other Matters section, there is a significant risk that UEI may not have met the requirement in fiscal year 1996.

We performed fieldwork at UEI's corporate office and at two campuses from October 13, 1998 through October 29, 1998 and from January 4, 1999 through January 8, 1999. Our audit was performed in accordance with generally accepted government auditing standards appropriate to the scope of the review described above.

Statement on Management Controls

As part of the review, we gained an understanding of UEI's management control structure, and its policies, procedures, and practices applicable to the scope of the audit. We assessed the level of control risk to determine the nature, extent, and timing of our substantive tests. For this report, we assessed management controls related to the institution's calculation and reporting of its percentage of revenues from non-Title IV sources.

Because of inherent limitations, a study and evaluation made for the limited purposes described above would not necessarily disclose all material weaknesses in the control structure. However, our assessment disclosed material weaknesses in the procedures used to calculate and report the percentage. These weaknesses are discussed in the Audit Results and Other Matters sections of this report.

Attachment

United Education Institute's Response to the Report

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June 4, 1999

VIA OVERNIGHT MAIL

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801 I Street, Suite 219
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Re: United Education Institute, Los Angeles, CA

Dear Ms. Pilotti:

As you know, this Firm represents United Education Institute (UEI). Please find attached UEI's written comments and response, with exhibits, to the proposed Office of Inspector General report (ACN A0990002). In this connection, we appreciate your courtesy in providing UEI with the opportunity to file these comments.

If you have any questions, please feel free to contact me.

Sincerely yours,


Peter S. Leyton

PSL/
Enclosure

fc: Abdi Lajevardi

United Education Institute,
Los Angeles, California
Response To The Office Of
Inspector General's
Audit Report
ACN A0990002

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EXHIBIT LIST

1. OIG Draft Report
2. United States Department of Education Eligibility and Certification Approval Report
3. Declaration of Fred Keivanfar
4. February 19, 1994, Notice of Proposed Rulemaking
5. April 29, 1994, Preamble to the Final Regulations
6. Opinion of West & Company, CPAs
7. Declaration of Nancy Broff
8. Opinion of Winther, Stave & Co., LLP, CPAs
9. Letter from Sharon H. Bob regarding Request for Confirmation on 85/15 Rule.
10. Letter from David L. Steiner regarding Institutional Loans in the 85/15 Percent Calculation.
11. Statements of Financial Accounting Concepts No. 6
12. SAS 69
13. Guide to Preparing Financial Statements
14. Decision in the Matter of Blair Junior College
15. Decision in the Matter of Nettleton Junior College
16. Opinion of Knutte & Associates, P.C., CPAs regarding Institutional Loans

UNITED EDUCATION INSTITUTE'S
RESPONSE TO THE OFFICE OF INSPECTOR
GENERAL'S DRAFT AUDIT REPORT
ACN A0990002

I.
PRELIMINARY STATEMENT

On March 26, 1999, the Office of Inspector General ("OIG") issued a draft audit report to United Education Institute ("UEI"), Audit Control Number A0990002 ("Draft Audit", *Exhibit 1*). The audit focused solely upon UEI's compliance with what is commonly referred to as the 85 Percent Rule.¹

The Draft Audit concludes that UEI's percentage of non-Title IV revenue in the fiscal year ended October 31, 1997 and October 31, 1998 was 8.8 percent and 6.1 percent, respectively.² *Exhibit 1* at page 3. In contrast, the School reported that 16.3 percent and 15.1 percent of the revenue was from non-Title IV sources for fiscal years 1997 and 1998, respectively. *Exhibit 1* at 3.

The significant differences between the percentages reported by the Institution and those calculated by the OIG are as a result of the OIG excluding all institutional loan principal amounts as non-Title IV revenue. *Exhibit 1* at 4-5. The Draft Audit takes this position on the grounds that these amounts were not revenue received at the time the loans were made. The OIG recommends that the Office of Student Financial Assistance take an emergency action to terminate UEI's participation in the Title IV programs and seek the return from UEI of about \$21.8 million in Title IV grants and loans disbursed since January 1, 1997. * *Exhibit 1* at 6.

For all of the reasons advanced below, UEI submits that the OIG conclusions and recommendations are unfounded and inappropriate and, further, that UEI is protected from the penalty the OIG recommends on the grounds, among others, that it acted in good faith reliance on the instructions given by the Secretary.

¹ Under the 85 Percent Rule, at least 15 percent of a proprietary school's revenue had to be derived from non-Title IV sources. 20 U.S.C. § 1088(b)(6)(section 481(b)(6) of the HEA) and 34 C.F.R. § 600.5(a)(8). On October 7, 1998, the HEA was reauthorized as part of which this provision was amended to require that at least 10 percent of a proprietary school's revenue has to be derived from non-Title IV sources. Section 102 of the Higher Education Amendments of 1998. The Department has not issued any formal guidance with respect to the effective date of this provision, however, it has informally advised the affected community that the 10 percent rule is effective with respect to any fiscal year ending on or after October 7, 1998.

² "Title IV" refers to those programs authorized under the Higher Education Act of 1965, as amended.

* OIG Notation: The OIG recommendation is to require that UEI return Title IV funds received after October 31, 1997. As of October 31, 1998, these totaled about \$21.7 million.

II. BACKGROUND

UEI is a participating proprietary institution of higher education that was founded in 1982 as United Electronics Institute. It has a main location in Los Angeles and approved additional locations in Brea, Huntington Park, San Diego, Ontario, Van Nuys and California. *Exhibit 2 (ECAR)* & 3 (*Declaration of Fred Keivanfar*). UEI is a California corporation owned by several individuals including its Chief Executive Officer, Abdi Lajevardi, and Fred Keivanfar, Vice-president for Financial Planning. UEI offers approved educational programs designed to prepare individuals for gainful employment in recognized occupations in the allied health, business and information technology fields. There are presently about 2,000 students enrolled in programs at all UEI locations combined and about 350 people employed as faculty and staff including the management. *Exhibit 3.*

III. THE 85 PERCENT RULE

The 85 Percent Rule was enacted in 1992. It provided that proprietary institutions of higher education must derive "at least 15 percent" of their revenues from non-Title IV sources. Section 481(b)(6) of the HEA. According to the Secretary, a principal purpose of the law is to require proprietary institutions to attract students based on the quality of their programs, not because they offer Title IV aid. *Exhibit 4, 59 Fed. Reg. 6446, 6448 (Feb. 10, 1994).*

Final regulations were promulgated on April 29, 1994. *Exhibit 5.* Congress, however, delayed their effective date to July 1, 1995. Pub.L.103-333; see 34 C.F.R. § 600.5(a)(8). The regulations require all proprietary institutions to disclose the percentage of their revenue derived from Title IV, HEA programs, as defined at section 600.5(d), in a footnote to their annual audited financial statements. 34 C.F.R. § 668.23(d)(4).

The Secretary requires a proprietary institution to determine the percentage of its revenue from Title IV and non-Title IV sources by dividing the amount of Title IV funds the institution used to satisfy tuition, fees and other institutional charges by the sum of revenues generated by the institution from tuition, fees and other institutional charges for students enrolled in eligible programs as defined in 34 CFR § 668.8. See 34 C.F.R. § 600.5(d)(1).

Revenue is defined in terms of what has been received by the institution during the last complete fiscal year, however, this concept is not further defined to exclude constructive receipt of funds. *Id.* at § 600.5(d)(2)(i) and see *Exhibit 6 at 3 (Opinion of West & Co., CPAs)* and *Exhibit 16 at 2 (Opinion of Knutte & Associates, CPAs)*. In the notice of proposed rulemaking ("NPRM") that was published to implement this provision, the Secretary briefly discussed his interpretation of the term "revenue." *Exhibit 4, 59 Fed. Reg. at 6448.*

He said that he opted for what he regarded as a "middle ground between counting only the income received from students' tuition and fees and counting as revenue income from businesses that are owned and operated by the institution, regardless of the relationship between the educational institution and the businesses." *Id.* & *Exhibit 5*, 59 Fed. Reg. 22324, 22327-328 (April 29, 1994).

In the final regulation, the Secretary stated that institutions are to use a cash basis of accounting for title IV, HEA program funds, and revenue. *Exhibit 5* at 22324, 22328. Neither the regulation nor the preamble further define this phrase and, as pointed out by Knutte & Associates, there is no definition of cash based accounting. *Exhibit 16* at 2. Rather, what the Secretary created was a "regulatory" basis of accounting governed by the rules established by the Secretary in regulation and otherwise. *Exhibit 6*.

This point can be well illustrated even within the context of the 85 Percent Rule itself. For example, the Secretary not only said that institutions could count institutional scholarships and loans in the denominator of the fraction but that institutional matching funds, such as are required under the Federal SEOG and Federal Perkins programs, could be included in the denominator of the fraction as part of the non-Title IV funds. *Exhibit 5* at 22327.

IV. UEI'S CALCULATION OF ITS NON-TITLE IV REVENUE WAS IN ACCORDANCE WITH LAW

The OIG asserts that UEI should not have treated the principal amount of the institutional loans that it awarded to students to pay for tuition, fees and institutional charges as non-Title IV revenue in the denominator of the 85 or 90 percent calculation for the fiscal years in which the loans were made. *Exhibit 1* at 4-5. The OIG reaches this conclusion because it does not consider the loan when made to be "revenue received" as defined in § 600.5(d)(2)(i). *Id.*

This conclusion is specifically based on a definition of revenue set forth in Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Concepts No. 6. *Exhibit 1* at 4. The FASB Concept defines revenue as "inflows or other enhancements of assets" and "actual or expected cash inflows (or the equivalent)". *Id.*

Any analysis of this position must first start with the law. In this regard, a principal source of guidance is the preamble to the final regulations in which the Secretary said that

"an institution is not prohibited from including institutional charges that were paid by institutional scholarships and institutional loans as revenue in the denominator of the fraction...provided that the scholarships and loans

are valid and not just part of a scheme to artificially inflate an institution's tuition and fee charges." 59 Fed. Reg. 22324 (April 29, 1994), *Exhibit 5*.

Institutions and accountants reviewing this language have frequently concluded, without qualification, that the above quoted statement clearly meant what it says, that is, that institutional loans could be treated as revenue in the denominator of the fraction. See *Exhibits 3, 6, 7, 8 & 16*. The OIG has focused on the word "paid" in the above quoted statement to argue that the Secretary only meant to treat as revenue those payments made on the loan as an inflow of revenue or cash from a source external to the institution. *Exhibit 1 at 4-5*.

This argument is misplaced. Among other things, SFAC 6 is not intended to define the timing of recognition of revenue. *Exhibit 16 at 2*. Cash basis is not a GAAP concept, as such, the source of authority to interpret the Secretary's regulation and comments is not SFAC 6 but rather the Secretary's own guidance, as limited as that may be. *Id.* Simply put, the Secretary's straight forward language means that if the loans are valid and not part of a scheme to artificially inflate tuition and fees, then they may be counted as revenue in the denominator of the fraction at the time that the loan is credited or posted to the student's account.

Institutions and their accountants have also recognized, however, that the regulation and preamble were not a model of clarity. As such, many sought additional guidance. West & Co.'s efforts to obtain guidance from the Office of Student Financial Assistance and the Office of General Counsel were met with the comment that "there should be no need for further clarification" beyond what had been published. *Exhibit 6 at 3*.

Another accountant, Ms. Tostenrud, of Winther, Stave & Co., LLP, in Spencer, Iowa, called Ms. Leibovitz, the person designated by the Department in the final regulation as the point of contact for any questions involving the 85 Percent Rule. *Exhibit 8 at 1* and *Exhibit 5 at 22324*. Others such as Dr. Sharon Bob, a financial aid consultant, and the accounting firm of Ehrhardt Keefe Steiner & Hottman, PC, of Denver, Colorado, sought guidance and confirmation in writing. *Exhibits 9-10*.

On May 13, 1994, within two weeks after the final regulation was published, Dr. Sharon Bob, a well known financial aid consultant, wrote Ms. Leibovitz asking for confirmation that institutional loans could be treated as revenue in the denominator of the fraction in the year in which the loans were made. *Exhibit 9*. On August 24, 1994, about three months later, Ms. Leibovitz responded with countersignature evidencing her agreement with Dr. Bob's interpretation of the regulation on this point. The fact that it took Ms. Leibovitz three months to respond indicates that the affirmation was provided only after a deliberative and well reasoned consideration of the question.

At about the same time that Ms. Leibovitz was considering her response and without either party knowing about the other, Ms. Tostenrud called Ms. Leibovitz in early August to ask a series of questions about the Rule. *Exhibit 8*. When Ms. Tostenrud called, she had a series of questions to ask, all of which are attached to her letter attached as Exhibit 8. The second question on her list is whether the note receivable can be treated as a payment on the account in the year in which the institutional loan was made. Ms. Leibovitz directed Ms. Tostenrud to call Mr. Pat Howard of the OIG to obtain answers to her questions.

On August 16, 1994, she spoke with Mr. Howard. *Id.* Mr. Howard's answer was "yes", the amount of the loan could be treated as a payment on the account so long as the loan was a valid or real loan, exactly as UEI did. *Id.* Coincidentally or not, Ms. Leibovitz responded to Dr. Bob's letter within days after Ms. Tostenrud's conversation.

The letter countersigned by Ms. Leibovitz, Mr. Howard's response to Ms. Tostenrud and UEI's treatment of institutional loans are all fully consistent. About two years later, in 1996, another accounting firm wrote Ms. Leibovitz and asked the same question. *Exhibit 10*. On the Department's behalf, Ms. McCullough of the Policy Division also answered with a yes.

This information and, in particular, Dr. Bob's letter, were widely disseminated around the country and among proprietary institutions. See e.g. *Exhibit 6 at 4 (West & Co. relied on the letter and disseminated it) and Exhibit 7 at ¶ 12 (Declaration by Nancy Broff, General Counsel, Career College Association indicating that Leibovitz was appropriate person to respond to this issue and that CCA widely disseminated the letter)*. Others such as Dr. Bob herself and this Firm widely disseminated it as well.

As noted in Dr. Bob's countersigned letter, the question was of profound importance to the proprietary sector which was why she specifically wanted a countersignature. The letter could not answer the question any more clearly.

UEI and its accountant's interpretation of the law is fully consistent with the regulation, the preamble to the regulation and the "supplementary" guidance issued by the Department and the OIG. Their interpretation and application of this interpretation of the 85 Percent Rule was made in good faith reliance on all available evidence and instruction. *Exhibit 3*. In this regard, it should also be noted that the OIG found that UEI's loan program is valid and not part of a scheme to artificially inflate tuition and that loans were routinely repaid by borrowers. *Exhibit 1 at 5, footnote 5*.

V.
**THE DEPARTMENT IS OBLIGATED TO APPLY ITS REGULATIONS
UNIFORMLY**

The Higher Education Act requires the Secretary to uniformly apply and enforce his regulations throughout the country. 20 U.S.C. § 1232 (c). See *Chula Vista City School Dist. V. Bennett*, 824 F.2d 1573, 1583 (Fed. Cir. 1987), cert. den., 484 U.S. 1042 (1988); *In the Matter of Blair Junior College*, Dkt. No. 93-23-SP (June 1, 1994)(Dec. of ALJ Cross) at 26 (Exhibit 14); *In the Matter of Nettleton Junior College*, Dkt. No. 93-29-SP (June 8, 1994)(Dec. of ALJ Cross)(Exhibit 15). This principle is embodied in the concept of equal protection of the law. Equal protection "is essentially a direction that all persons similarly situated should be treated alike." *City of Cleburne, Texas v. Cleburne Living Center*, 473 U.S. 432, 439 (1985).

Were the Department to adopt the rules of interpretation now being advanced by the OIG for 85/15 analysis to past years, this fundamental principle would be violated since other similarly situated schools are not being treated alike.

VI.
**UEI IS ENTITLED TO RELY ON THE
GUIDANCE PROVIDED BY THE DEPARTMENT
WITHOUT PENALTY OR THE THREAT OF PENALTY**

UEI has acted in a manner consistent with the Secretary's comments, other Departmental guidance and the OIG. The fact that the Department provided some very limited guidance in the *Federal Register* and in correspondence is not unusual. See e.g. Exhibits 14 & 15, *In the Matter of Blair Junior College at 26 and In the Matter of Nettleton*.

As noted by Administrative Law Judge Cross in *Blair*,

"ED has established a so-called 'safe harbor' for past actions. If a school fully acts in the manner instructed by OSFA, there will be no penalty for such past action if OSFA subsequently decides to change a policy direction." *Blair at 27 quoting from Associated Technical College, Dkt. No. 91-112-SP at 27, (Feb. 3, 1993)(Dec. of ALJ Cross), affirmed by the Secretary, July 23, 1993; see also Nettleton*.

As also noted in *Blair and Nettleton*, another authoritative acknowledgement of the 'safe harbor' principle is found in a Declaration filed several years ago in a case in the U.S. District Court for the District of Columbia by Ernest C. Canellos. Mr. Canellos is now an administrative law judge with the Department and was then Acting Deputy Assistant Secretary for OSFA. In the Declaration, Judge Canellos specifically admitted that the Secretary recognized

that guidance given by the Department that is relied upon by schools creates a 'safe harbor' from imposition of a penalty that might otherwise be imposed for past action. *Id.*

As such, even assuming, arguendo, that the OIG position is valid, UEI, which acted in accordance with available guidance, is entitled to a safe harbor from any penalty for its treatment of principal amounts of institutional loans as revenue in the denominator of the 85/15 and 90/10 calculation for fiscal years 1997 and 1998.

VII.
STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6
DOES NOT ESTABLISH A STANDARD

Statement of Financial Accounting Concepts No. 6 ("SFAC 6") upon which the OIG relies, states in its preamble that the:

"Statements of Financial Accounting Concepts do not establish standards prescribing accounting procedures or disclosure practices for particular items or events, which are issued by the Board as Statements of Financial Accounting Standards. Rather, Statements in this series describe concepts and relations that will underlie future financial accounting standards and practices and in due course serve as a basis for evaluating existing standards and practices." *Exhibit 11 at 1 (emphasis added).*

As noted by Knutte & Associates, SFAC 6 states that it "contains no conclusions about recognition of revenues or of any other element." *Exhibit 16 at 2.* Notwithstanding these clear pronouncements that the Concepts are not standards, the OIG cites SFAC 6 for the proposition that it is "the standard" to support all of its conclusions about the inappropriateness of including the revenue from the school's institutional scholarships in the calculation. The accounting profession has an established hierarchy of Generally Accepted Accounting Principles ("GAAP"). See *Statements on Auditing Standards ("SAS") No. 69, Exhibit 12 at 398.*

Under this hierarchy, auditors are expected to look to the sources of information identified in the hierarchy for guidance in conducting an audit and to rely, as much as possible, on the sources of information that provide guidance that are at the lowest Level of the hierarchy. *Exhibit 12.*

So, for example, the most authoritative sources of guidance for an auditor performing a specific audit are at "Level 1". If guidance is not available at "Level 1", it is expected that the auditor will look to "Level 2" for guidance and so on up the ladder. *Id.* Guidance found at Level 5, which is the level where the Concepts are found, is the least authoritative material. *Exhibit 12.* Reliance on the Concepts in the manner that the OIG has used them would be acceptable only if

there is no other guidance available at a lower level. As has been shown, however, other more appropriate and authoritative sources of guidance do exist at lower levels of the hierarchy.

Reliance on SFAC 6 is also misplaced because it is a statement written and intended to provide thoughts for future financial accounting in terms of GAAP. *Exhibit 12*. GAAP represents accounting principles intended to assist in the preparation of accrual based presentations of financial information. *Id.* Again, SFAC 6 is not a standard and not a document upon which the OIG can properly rely for the conclusion that UEI's revenue from institutional scholarships cannot be included in the 85/15 calculation.

VIII.

THE 85 PERCENT RULE IS NOT A PURE CASH BASED ANALYSIS

The OIG interpretation of the 85 Percent Rule ignores the fact that the Secretary is entitled to establish his own financial standards. *Exhibit 12 at 395*. As such, he has the authority to modify accounting rules and create a "regulatory basis" of accounting. For example, West & Co. looked at *Statements on Accounting Standards No. 62* ("SAS 62") which addresses examples of "Other Comprehensive Basis of Accounting" ("OCBOA"). *Exhibit 6, Attachment 1*; see also *Guide to Preparing Financial Statements*, Volume 2, Chapter 9, "Cash and Tax Bases and Other Comprehensive Bases of Accounting", *Exhibit 13*.

SAS 62 describes alternative bases of accounting including a regulatory basis, as dictated by the applicable agency, and modified cash basis of accounting. West & Co. conclude that the 85 Percent Rule falls into the category of "regulatory" basis within the meaning of OCBOA. This conclusion is supported by the language in the preamble to the final regulations, the guidance given by the Department and the OIG in 1994 and 1996 that has previously been cited and other regulations of the Department such as those in the cash management area, 34 CFR Part 668, Subpart K.

The Department's cash management regulations provide that "...an institution makes a disbursement of Title IV, HEA program funds on the date that the institution credits a student's account at the institution..." 34 CFR § 668.164(a)(1)(emphasis added). Schools can credit students account ledgers before any cash is received and when done, a disbursement has taken place. This regulatory position was initially published in December 1994.³ One common example of when this occurs is illustrated by the Department's payment by reimbursement regulations. These regulations state that

³ The regulatory provision was inadvertently removed in technical corrections on June 30, 1995 but reinstated on September 27, 1996. *Federal Register*, June 30, 1995 at 34432 and *Federal Register*, September 27, 1996 at 49042.

"Under the reimbursement payment method... an institution must first make disbursements to students and parents for the amounts of funds those students and parents are eligible to receive under the Federal Pell Grant, Direct Loan, and campus based programs before the institution may seek reimbursement from the Secretary for those disbursements. The Secretary considers an institution to have made a disbursement if the institution has either credited a student's account or paid a student or parent directly with its own funds;" 34 CFR § 668.162(d).

Crediting a student's account as described immediately above is no different than the act of posting an institutional loan to an open account. *Exhibit 6 at 3.*

Another example of why the 85 Percent Rule qualifies for analysis under the concept of regulatory basis and not pure cash basis is reflected in the Secretary's treatment of institutional matching funds. For example, the Secretary said that institutional matching funds, such as are required under the Federal SEOG and Federal Perkins programs, could not be included in the numerator of the fraction as part of the Title IV funds. *Exhibit 5 at 22327.*


By responding to the comments in this fashion, the Secretary has clearly stated that these funds can be included in the denominator as non-Title IV revenue. In this regard, the Secretary's treatment of these "funds" is no different than what UEI did and what schools are directed to do in the cash management regulations. It also represents further evidence that the Secretary did not intend for the 85 Percent calculation to be based on pure cash based accounting.

IX. CONCLUSION

UEI has demonstrated that the institutional loans made and credited to student's accounts in FY 1997 and FY 1998 were properly included as non-Title IV revenue in the denominator of the 85/15 and 90/10 fractions. This conclusion is fully supported by the Secretary's statement in the preamble to the final regulations, other guidance from the Department and the OIG itself, and other Department regulations such as those in cash management. This conclusion is also supported by application of the correct accounting standard which, in this matter, is not pure cash based accounting but rather a regulatory basis of accounting.

UEI has also shown that it acted in good faith and without intent to deceive or defraud and that it is entitled to a safe harbor against the imposition of any penalty associated with its treatment of the institutional loan revenue. For all of these reasons, the OIG should withdraw its draft recommendations and accept UEI's participation in Title IV for both fiscal years.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read "Peter S. Leyton". The signature is fluid and cursive, with the first name "Peter" and last name "Leyton" clearly distinguishable.

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Date: June 4, 1999

**U.S. Department of Education
Office of Inspector General Note**

The exhibits of United Education Institute's response are available in our office and will be provided upon request.

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